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SUBJECT: UNEXPECTED Q4 TAIWAN TRADE SURPLUS PUSHES UP GDP

SUMMARY

1. As recently as November, Taiwan's official data projected a sharp decline in the overall trade surplus. However, an unexpected expansion of Taiwan's 2005 trade surplus will likely push up real GDP for 2005 and lays the basis for growth in 2006. Exports enjoyed accelerated growth as developed nations sought to replenish declining inventories. Import growth slowed in 2005 as firms dramatically slowed investment for expansion of industrial capacity. Taiwan's industrial relocation offshore led to increases in exports to Greater China and ASEAN and a leveling-off of shipments to the United States and Europe. Taiwan's trade relationship with Greater China is a key factor in maintaining its overall trade surplus. END SUMMARY.

#### Trade Surplus Grows Unexpectedly

2. Taiwan's 2005 trade surplus expanded an unexpected 27% from last year to reach US\$7.78 billion. As recently as November, the Directorate General of Budget, Accounting and Statistics (DGBAS) predicted that the 2005 trade surplus would shrink 24% to US\$4.66 billion, and the Taiwan Institute of Economic Research (TIER) anticipated that the trade surplus would shrink 5% to US\$5.8 billion. The full year figures for 2005, though, show that Taiwan's exports grew 8.8% from 2004 to US\$189.39 billion, while its imports rose 8.2% to US\$181.61 billion.

#### Trade Performance Unexpected in Q4 of 2005

3. Trade performance in Q4 of 2005 far exceeded expectations. Exports in Q4 grew 14.2% from a year ago, higher than the 13% growth estimated in November 2005 by the DGBAS. The 14.2% export growth in Q4 was also higher than the 12.9% growth projected by TIER. Meanwhile, Taiwan's imports in Q4 inched up 0.9%, far less than the 6.6% growth estimated by the DGBAS and the 4% growth expected by the TIER.

4. Double-digit growth in exports, together with imports leveling-off, drove Taiwan's trade surplus in Q4 of 2005 to a new high of US\$5.85 billion. This performance allowed the annual figure to make up ground on the practically balanced trade picture for the last four quarters. Q4 of 2004 produced a US\$0.2 billion deficit, while Q1 and Q2 this year showed trade surpluses of US\$0.28 billion in Q1 and US\$0.13 billion, respectively.

#### Export Sector Benefits from Asian Integration

5. Declining inventory stocks in developed nations and Asian economic integration contributed to export growth in Q4. Depletion of excess inventories in developed countries, which began to build up in late 2003 and early 2004, contributed to accelerated growth in export orders received by Taiwan in 2005 from 15% in Q2 to 23% in October and November. The y-o-y growth in orders from the United States rose from 5.9% in Q2 to 14% in Oct.-Nov. Meanwhile, the growth rate in export orders from Europe increased from 15% to 31.6%. Export orders from Japan in the first 11 months of 2005 were 37% higher than the same period of 2004.

#### Accelerated Growth in Exports to Asian Nations

6. Taiwan manufacturing firms also increased production of

export orders in overseas locations (mainly in China and Southeast Asia) from 37% to 43% in 2005. Consequently, double-digit growth in export orders last year has been translated into an accelerated growth in Taiwan's 2005 exports (mainly production inputs) to Greater China (Hong Kong and China) from 8% in Q1 and 5.5% in Q2 to 23% in Q4. Growth in exports to ASEAN also accelerated from less than ten percent in Q1 to exceed 20% in Q4.

#### Shipments from Taiwan to Developed Markets Leveling off

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17. As Taiwan firms' increasingly rely on offshore production bases, goods shipped directly from Taiwan to markets in the United States and Europe did not enjoy the same accelerated growth that export orders experienced. Exports to Europe in 2005 contracted 0.8% from 2004, while exports to the United States in 2005 inched up only 1.4%. By quarter, exports to the United States even reversed from a y-o-y growth of 7% in Q1 to a contraction of 2.2% in Q3 and a moderate growth of 0.8% in Q4. Japan was an exception to this pattern as Taiwan's exports to Japan grew ten percent in 2005, higher than the average of 8.8% growth in exports to the world.

#### Export Share: More to Greater China, Less to USA

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18. This leveling-off of exports to OECD countries contributed to declines in percentage shares of exports to these markets. Taiwan's exports to the United States in 2005 totaled US\$28.5 billion, equivalent to 15% of its exports to the world, down from 16.2% in 2004 and 32% in 1990. The share of exports to Europe also declined from 18% in 1990 to 13.5% in 2004 to 12.3% in 2005.

19. Accelerated growth in exports to East Asia has, of course, contributed to an increase in the share of exports to Greater China from 13% in 1990 to 37% in 2004 and 39% in 2005. The export share to ASEAN also rose from less than ten percent in 1990 to 13% in 2004 and nearly 14% in 2005.

#### Changing Export Composition

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10. Electronics, the backbone of Taiwan's manufacturing sector, enjoyed better export sales in 2005, while information and telecommunication (IT) products continued to contract due to industrial relocation. Growth in exports of electronic parts and components in 2005 accelerated from below 5% in Q1 and Q2 to 26% in Q4. Optical components (including liquid crystal display (LCD) panels) moved from a negative growth in Q2 to expanding in Q3, and the y-o-y growth rate in Q4 reached 80% in Q4. Electronic parts/components and optical components in 2005 increased to 31% of Taiwan's total exports from 29% in 2004.

11. These electronics products expanded at the expense of IT goods as those assembly lines have relocated to China. Consequently, IT exports in 2005 dropped 18%, even as Taiwan firms saw orders for IT products grow 23% in the first 11 months this year. IT products' export share in 2005, therefore, declined to 5.5% from 7.4% in 2004.

12. Higher petroleum costs have driven up prices of petrochemical and plastic products. Consequently, petrochemical exports in 2005 grew 28% to US\$9.86 billion, and exports of plastic products increased 16.5% to US\$12.5 billion. The export share for these two categories in 2005 rose to 13% from 11.6% in 2004.

#### 2004 Capacity Overexpansion Slows Import Growth in 2005

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13. Brisk export sales after the SARS crisis in early 2003 prompted Taiwan's manufacturing sector to start a new round of production capacity expansion that has now slowed to a crawl. Private investment reversed from a decline of 0.3% in 2003 to grow by 31% in 2004. The y-o-y growth in imports of capital goods even shot up to 55% in Q2 of 2004. Overexpansion contributed to an increase in excess production capacity in early 2005. Facility utilization rates for semiconductor plants declined from 100% in early 2004 to 60-75% in Mid-2005, and the average ratio for liquid crystal display (LCD) factories also fell from 100% to 75%.

14. Correspondingly, manufacturing plants dramatically slowed investment in 2005 in order to better utilize their existing facilities. As a result, private investment growth slowed steadily from 38% in Q2 of 2004 to 9% in Q2 of 2005. Private investment even contracted in the second half of 2005, down 2% in Q3 and down 3.2% in Q4.

15. Imports have reflected the investment trend, with a steady slowdown in import growth from 40% in Q2 of 2004 to 0.9% in Q4 of 2005. Imports of capital goods even

contracted in the second half of 2005, with the rate of decline accelerating from -4% in Q3 to -23% in Q4. Capital goods accounted for 17% of Taiwan's total imports in 2005.

#### China Replaces USA as 2nd Largest Source of Imports

¶16. While Taiwan increases its exports (mainly production inputs) to China, Taiwan also increases its imports from China in the process of cross-Strait economic integration. Imports from China are partly used as inputs for re-exports after simple assembly. Taiwan's accession to the World Trade Organization in early 2002 has also contributed to an increase in Taiwan's imports of labor-intensive consumer goods from China.

¶17. Taiwan's imports from China in 2005 grew 19.5% from 2004 to reach US\$19.9 billion. China supplied 11% of Taiwan's imports in 2005, up from 10% in 2004. In contrast, the share of imports from the United States declined from 13% in 2004 to 11.6% in 2005. China has surpassed the United States to become the second largest source of Taiwan's imports in September when the import share from China was 10.6% vs. the 10.1% for imports from the United States. The gap between the import shares for these two sources broadened in December 2005 to 12.3% for imports from China vs. 11% for imports from the United States.

#### Higher Petroleum Import Cost

¶18. Raw materials and semi-finished goods account for over 70% of Taiwan's total imports. Over the past two years, higher petroleum prices have had the single biggest impact on Taiwan's trade account than any other products. Petroleum imports in 2005 surged 40% to US\$18.2 billion, and this category's share of total imports in 2005 increased to 10% from 7.8% in 2004 and only 6% in 2002. Saudi Arabia and Kuwait have been Taiwan's two major sources of petroleum. Oil imports from these two countries in 2005 shot up 41% to reach US\$11.7 billion. Imports of raw materials and semi-finished goods in 2005 grew 10% from 2004 to US\$130.1 billion.

#### Private Consumption Remains Strong

¶19. Private consumption remained stable in 2005. Imports of consumer goods in 2005 grew 14% to US\$15.7 billion. Consumer goods accounted for 10% of total imports in 2005, up from 8% in 2004.

#### COMMENT

¶20. As recently as January 16, TIER was projecting that Taiwan's 2005 real GDP would be 3.54% and that growth in 2006 would be about 4%. The unexpected growth in the trade surplus in Q4 may push up Taiwan's growth to about 4% for 2005 and may lay the basis for even higher projections for ¶2006.

¶21. Apparently, expansion of cross-Strait trade has substantially benefited Taiwan's economy. Absent the trade surplus of US\$50 billion with Greater China, Taiwan would have run a global trade deficit in 2005. Without cross-Strait trade, Taiwan might well have begun to experience trade deficits in the 1990s.

PAAL